COMMITTEE ON CAPITAL MARKETS REGULATION

April 7, 2014

Secretariat
Financial Stability Board
c/o Bank for International Settlements
CH-4002, Basel
Switzerland

VIA ELECTRONIC MAIL: fsb@bis.org

Re: "Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies" (the "**Consultative Document**")

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Consultative Document,[1] released by the Financial Stability Board ("**FSB**") in consultation with the International Organization of Securities Commissions ("**IOSCO**"). The Consultative Document was prepared in response to a request from the G20 Leaders to "develop for public consultation methodologies for identifying" non-bank non-insurer ("**NBNI**") global systemically important financial institutions ("**G-SIFIs**") by the end of 2013, specifically including (i) finance companies, (ii) market intermediaries, and (iii) investment funds.[2]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-three leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

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[1] Financial Stability Board & OICU-IOSCO*, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* 1 (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.htm.
Non-Bank Non-Insurer Global Systemically Important Financial Institutions 1 (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.htm.
[2] *Id.* at 2.

The Committee has frequently commented on the issue of SIFI designation, and in our view, the Consultative Document presents an incomplete picture of the systemic risks associated with NBNI financial entities.[3] We have generally opposed use of the blunt tool of SIFI designation with respect to non-bank financial institutions that do not pose appreciable levels of systemic risk. We have elsewhere argued that this category includes a variety of asset managers—including mutual funds, hedge funds, and private equity funds—as well as finance companies and traditional insurers.[4] Indeed, the Consultative Document itself appears to hint that application of a bank-centric G-SIFI model to funds may be inappropriate given the important distinctions between fund investors and bank depositors.[5] As an alternative to the Consultative Document's contemplated approach, we would encourage the FSB to pursue an activity-based or product-based approach to systemic risk rather than focus narrowly on entity-by-entity designation.

While this letter sets forth the Committee's general concerns with respect to the Consultative Document, we would appreciate a further opportunity to comment at a later stage in the G-SIFI designation process—as well as the parallel SIFI designation process of the U.S. Financial Stability Oversight Council ("**FSOC**")—once the very general inquiry of the Consultative Document turns into a specific proposal.

Bank-Centric Approach to NBNI G-SIFI Designation

The Consultative Document proposes a series of assessment methodologies for identifying NBNI G-SIFIs. Similar assessment methodologies have been released in recent years by (i) the Basel Committee on Banking Supervision with respect to global

[3] *See* Letter from the Comm. on Capital Mkts. Reg. to Elizabeth M. Murphy, Secretary, U.S. Sec. and Exch. Comm. 1 (Nov. 1, 2013), *available at* http://capmktsreg.org/wp-content/uploads/2013/11/CCMR-asset-mgr-comment-ltr-2013-11-01.pdf; Letter from Comm. on Capital Mkts. Reg. to Neal Wolin, Acting Chairman, Fin. Stability Oversight Council 1 (Feb. 15, 2013), *available at* http://capmktsreg.org/wp-content/uploads/2013/02/FSOC.non-bank.SIFI_.comment.ltr_..pdf; Letter from Comm. on Capital Mkts. Reg. to Lance Auer, Deputy Assistant Secretary, U.S. Dep't of the Treasury 1 (Dec. 19, 2011), *available at* http://www.capmktsreg.org/pdfs/2011.12.19_SIFI_Comment_Letter.pdf; Letter from the Comm. on Capital Mkts. Regulation to Lance Auer, Deputy Assistant Secretary, U.S. Dep't of the Treasury 1 (Feb. 22, 2011), *available at* http://www.capmktsreg.org/pdfs/2011.02.22_FSOC_systemically_important_letter.pdf; Letter from the Comm. on Capital Mkts. Reg. to Timothy Geithner, Chair, Fin. Stability Oversight Council 1 (Nov. 5, 2010), *available at* http://www.capmktsreg.org/pdfs/2010.11.05_Volcker_Rule_letter.pdf.

[4] Letter from Comm. on Capital Mkts. Reg. to Neal Wolin, Acting Chairman, Fin. Stability Oversight Council 1, 1-2 (Feb. 15, 2013), *available at* http://capmktsreg.org/wp-content/uploads/2013/02/FSOC.non-bank.SIFI_.comment.ltr_..pdf.

[5] Financial Stability Board & OICU-IOSCO, *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* 1, 29 (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.htm.

systemically important banks ("**G-SIBs**")[6] and (ii) the International Association of Insurance Supervisors ("**IAIS**") with respect to global systemically important insurers ("**G-SIIs**").[7] In promulgating the Consultative Document, the FSB and IOSCO sought to maintain broad consistency with the methodologies for identifying G-SIBs and G-SIIs, with an "overarching objective" of identifying "NBNI financial entities whose *distress or disorderly failure*, because of their size, complexity[,] and systemic interconnectedness, *would cause significant disruption to the global financial system and economic activity across jurisdictions* (emphasis in original)."[8]

Throughout, the Consultative Document defaults to assessing NBNI financial entities according to rubrics originally designed for the *banking* sector. We are concerned that this bank-centric approach may continue beyond the initial identification stage to the imposition of capital, liquidity, or other bank-oriented regulatory devices, as has been suggested with respect to the SIFI designation of traditional life insurers and asset managers in the United States. In particular, capital requirements and leverage ratios have no place in the regulation of asset managers since asset managers are generally unlevered.[9] As the Consultative Document notes, NBNI entities "have very diverse business models and risk profiles that in many respects are quite different from banks and insurers."[10] As such, applying a banking framework to such entities may not be entirely appropriate; rather, as we suggest elsewhere in this letter, a shift in focus to the systemic risks posed by specific activities or products may be the more fruitful course.

Systemic risk in capital markets is not confined to or concentrated in a few discrete entities. Rather, it shifts with capital flows, which themselves are driven by investor preferences and other market dynamics. Regulating the systemic risk posed by capital markets requires, as discussed further below, a focus on market infrastructure and on systemically risky activities and products. Shoehorning a multiplicity of entities ranging from mutual funds to broker dealers to venture capital firms into a regulatory schema designed for the banking industry may lead to suboptimal regulatory outcomes. It is also unsupported by any empirical data adduced by the Consultative Document. At a minimum, any regulation of NBNI entities from a systemic risk perspective should be carefully tailored on an industry basis.

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[6] Bank for Int'l Settlements, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* 1 (Jul. 2013), *available at* http://www.bis.org/publ/bcbs255.pdf.

[7] International Association of Insurance Supervisors, *Global Systemically Important Insurers: Initial Assessment Methodology* 1 (Jul. 18, 2013), *available at* http://iaisweb.org/Supervisory-Material/Financial-Stability-Macroprudential-Policy-Surveillance-988.

[8] Financial Stability Board & OICU-IOSCO*, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* 1, 2 (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.htm.

[9] *See* Andrew G. Haldane, *The Age of Asset Management?* (Apr. 4, 2014), *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf

[10] Financial Stability Board & OICU-IOSCO*, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* 1, 3 (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.htm.

Assessment Pool Materiality Thresholds

As a preliminary step, the Consultative Document sets materiality thresholds for inclusion in the "assessment pool" for NBNI G-SIFIs, that is, the subset of financial institutions that will be initially considered as potential candidates for G-SIFI designation.[11] The Consultative Document highlights the "broad consistency" of the threshold figures with the corresponding G-SIB and G-SII thresholds.[12] For finance companies and market intermediaries, the threshold for consideration as a G-SIFI designee is US$100 billion in balance sheet total assets and US$100 billion in assets under management for investment funds.[13] Hedge funds are subject to an alternative threshold to be set between US$400 billion and US$600 billion in gross notional exposure.[14]

We do not consider an entity's size, however measured, to be the most appropriate threshold test. Strictly applied, a size threshold may lead to false positives and false negatives, subjecting large index funds to potential G-SIFI designation, while potentially missing the next Reserve Primary Fund. The proposed thresholds seem not to be strongly indicative of a potential threat to the *global* financial system, and the Consultative Document provides little evidence to the contrary. The proposed thresholds are also inconsistent with the G-SIB methodology applied to banks, which are not required to report their scores under the G-SIB factors unless their assets exceed €200 billion. Unlike banks, many investment funds are unleveraged and therefore are funded by 100% equity capital. We are concerned that there may not be a clear basis for applying a materiality threshold to investment funds that is less than half the size of the one applied to banks. A focus on systemically risky activities and products, assessed through reliance on *risk-based* metrics, is the preferable line of inquiry if the objective is to reduce systemic risk globally.

Moreover, even if size is ultimately adopted as the threshold test, the Consultative Document does not specify the precise methods of determining gross assets under management or gross notional exposure. Indeed, gross notional values as measures of risk may not be a sensible approach at all, particularly in the derivatives context, where notional values ignore netting and collateralization and vary wildly by asset class and duration. The risk profile of centrally cleared derivatives differs from uncleared derivatives. The Committee would urge the FSB to provide clarity on these points, taking cognizance of the approaches adopted by other regulators. For example, we would encourage the FSB to consult the applicable regulations adopted by the U.S. Securities and Exchange Commission, so that gross assets under management metric under the Consultative Document is consistent with the regulatory assets under management figure that funds are currently required to calculate and file on Form PF. More broadly, funds

[11] *Id.* at 8.
[12] *Id.* at 1.
[13] *Id.* at 9.
[14] *Id.* at 9.

are presently required to perform a wide array of risk exposure calculations for various regulators, both in the United States and elsewhere (*e.g.*, Form PF and "major swap participant" calculations in the United States, the Hedge Fund Survey in the United Kingdom, *etc*.). The Basel counterparty credit risk framework also includes adjustments to a derivative's notional value, considering factors such as maturity, duration and asset class, to more accurately capture the riskiness of a derivative position.[15] The global regulatory community has clearly recognized that the notional value of derivatives is not the appropriate metric for measuring market risk or counterparty risk. In the interests of regulatory efficiency, we suggest that the FSB look to all such existing measures, which are themselves the product of considerable deliberations by national regulatory bodies.

Scope of Consultative Document

The Consultative Document does not propose "any specific entities for designation or any policy measures that would apply to NBNI G-SIFIs."[16] However, the Consultative Document nevertheless applies to a broad range of entities, including (i) finance companies, (ii) market intermediaries (including broker-dealers), and (iii) investment funds.[17]

The NBNI financial subsidiaries of global banks and insurers that themselves are the subject of a G-SIB or G-SII designation are excluded from the scope of the Consultative Document on the grounds that the systemic significance of such subsidiaries is already adequately addressed at the consolidated group level.[18] The size threshold proposed for broker-dealers is $100 billion.[19] Indeed, the majority of broker-dealers in the United States (and elsewhere) of such size are already affiliated with a systemically important bank and thus already subject to supervision by the Federal Reserve.

The "investment funds" sector is defined to cover "collective investment schemes," including, without limitation, common mutual funds, money market funds, exchange traded funds, hedge funds, private equity funds, and venture capital, as well as potentially separately managed accounts that do not form part of such a collective investment scheme.[20] With respect to investment funds, the FSB identifies four alternatives for the scope of application, namely (w) funds, (x) families of funds, (y) asset managers on a standalone basis, and (z) asset managers together with their funds collectively.[21] The Committee would submit that it may not be sensible to aggregate

[15] *See* Bank for Int'l Settlements, *The Non-Internal Model Method for Capitalising Counterparty Credit Risk Exposures* (Jul. 2013), *available at* http://www.bis.org/publ/bcbs254.pdf
[16] Financial Stability Board & OICU-IOSCO, *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* 1, 2 (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.htm.
[17] *Id.* at 2.
[18] *Id.* at 8.
[19] *Id.* at 9.
[20] *Id* at 28.
[21] *Id.* at 7.

funds managed by a single manager for purposes of G-SIFI designation, as funds within the same family may have strikingly different strategies, risk profiles, and investor bases and can be wound down on a fund-by-fund basis. As the Consultative Document implies, the manager entity itself is generally not the key locus of risk in a fund complex. The "risks" created by families of funds are created by the pool of assets in a given fund—confounding a fund's assets with the balance sheet of its management entity is misleading and inaccurate.

Transmission of Systemic Risk

The Consultative Document identifies "transmission channels," that is, mechanisms by which, in the FSB's view, the "financial distress of an NBNI financial entity is most likely to be transmitted to other financial firms and markets."[22] The Consultative Document identifies three "channels" for the transmission of systemic risk, what it terms (i) the "exposures/counterparty" channel,[23] (ii) the "asset liquidation/market" channel,[24] and (iii) the "critical function or service/substitutability" channel.[25] While it provides a working definition of each of these channels, the Consultative Document provides little empirical evidence as to the likelihood that any particular NBNI entity or class of entities would provoke a contagious run, other than a generic allusion to "historical examples of financial distress or failures."[26] A careful study of the available evidence, if any, should be conducted prior to designation of any NBNI G-SIFIs pursuant to the Consultative Document's assessment methodologies.

For example, the Consultative Document attributes the systemic risk of the asset management industry to (i) the "exposures/counterparty channel" (*i.e.*, "distress or failure of an investment fund lead[ing] to losses or other impairment incurred by banks, brokers[,] and other counterparties"[27] engaging in funding or trading transactions with the fund) and (ii) the "asset liquidation/market channel" (*i.e.*, fire sales of fund assets provoked by runs on fund financing sources[28]). Nevertheless, little empirical evidence—or even qualitative discussion—is provided in the Consultative Document to support these claims.

The Consultative Document quite correctly notes a number of features of such funds that *distinguish* them from banks, eliminate or effectively mitigate the risk of runs or fire sales, and undermine the case for SIFI designation, including (i) the knowing exposure of fund investors to both the potential gains and losses of funds, as compared to bank depositors; (ii) the absorption of fund losses by the investor rather than the fund itself or its manager; (iii) the existence of fund-specific regulatory regimes that deter or

22 *Id.* at 3-4.
23 *Id.* at 3.
24 *Id.* at 3.
25 *Id.* at 3.
26 *Id.* at 7.
27 *Id.* at 29.
28 *Id.* at 29.

dampen liquidity outflows from funds (*e.g.*, redemption gates); and (iv) the fact that "funds close (and are launched) on a regular basis with negligible or no market impact."[29] Even where an asset manager exits the business or an investment fund fails, the resolution process is relatively straightforward from the perspective of investors and involves reassignment of their assets to another manager. Asset managers regularly go out of business with no larger systemic implications.[30]

The Consultative Document does not present evidence of asset interconnectedness between asset managers and other major financial institutions, such that the failure of an asset manager could trigger a chain reaction of failures of systemically significant banks and other financial counterparties. The Committee is skeptical that asset managers pose appreciable levels of systemic risk, in light of the fact that such entities are generally not engaged in material levels of borrowing from other financial institutions. (The history of Long-Term Capital Management L.P. ("**LTCM**") is a possible counterexample of an investment fund or asset manager that had sufficient interconnectedness to other financial institutions to pose potential systemic risk concerns. LTCM primarily received its funding from banks, which form of funding has since been subjected to strict regulatory limits, thus rendering this counterexample much less salient.)

To ensure that the G-SIFI designation process does not return a surfeit of false positives, what is necessary is a clearly defined quantitative test to identify only the most interconnected asset managers (if any). We suggest that the FSB *only* consider an asset manager for designation where its failure would cause a 10-20% decrease in the capital of another financial institution with over US$100 billion in assets. Where this test of asset interconnectedness is not met, any argument for G-SIFI designation would necessarily be weak.

We applaud the FSB for considering whether its designation methodology "should . . . be designed to focus on whether particular activities or groups of activities pose systemic risks."[31] The Committee would encourage the FSB to pursue this activity-based or product-based approach. Rather than attempt to identify individual entities that concentrate systemic risk to such a degree that they warrant different regulation than their competitors, we would encourage the FSB instead to assess activities or products that pose particular systemic risk and to regulate such activities or products broadly. Such a broad-based approach has already been employed with respect to regulation of, for example, derivatives trading (*e.g.*, central clearing and minimum margin requirements), as opposed to singling out the largest derivatives traders for enhanced regulation. We believe that a similar approach to regulating the asset management industry would be more fruitful than the use of G-SIFI designation of individual entities. If concerns over

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[29] *Id.* at 29.

[30] *See generally* Gregory Brown et al., *Are Hedge Funds Systemically Important?,* 20.2 Journal of Derivatives 8 (2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1689079.

[31] Financial Stability Board & OICU-IOSCO*, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* 1, 32 (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.htm.

such activities and products are clearly communicated to markets, market participants will be in a better position to evaluate the costs and benefits of such activities and products, thus doing far more to reduce overall risk in the system than merely designating a few large asset managers.

More broadly, designation of asset managers or their fund complexes as G-SIFIs could ultimately prove to be a self-defeating exercise, given the low levels of market concentration and highly competitive nature of this industry. According to the Investment Company Institute's *2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*, over 700 sponsors managed mutual funds in the United States in 2012, and "[l]ong-run competitive dynamics have prevented any single firm or group of firms from dominating the market."[32] By the Herfindahl-Hirschman Index, a measure of market concentration that assigns a numerical weight based upon relative size and number of firms in an industry, the market concentration of the mutual fund industry was 465 as of December 2012 (industries with index numbers below 1000 are considered "unconcentrated").[33] Thus, to the extent that G-SIFI designation is accompanied by further policy measures that make investing in such funds less desirable from an investor perspective, designation of a handful of asset managers or fund complexes as G-SIFIs may shift capital flows to smaller competitors, undermining competitiveness and achieving no substantial regulatory purpose. In fact, it would be destructive and distort markets.

While the Consultative Document is at pains to disclaim that any decision has yet been made with respect to the SIFI designation of various classes of NBNI financial entities,[34] by failing to provide concrete arguments for the channels or their applicability to the entities in question, the Consultative Document does not provide a reasoned basis for any such future designation. As noted above, we would encourage the FSB to explore the targeting of systemically risky activities and products on a market-wide basis rather than attempt to force a handful of asset managers into the G-SIFI framework.

Procedural Issues

The Committee urges the FSB to adopt a fully transparent process in determining whether or not to designate any NBNI entities as G-SIFIs. Other commenters have faulted the designation process as applied to G-SIBs and G-SIIs, noting in particular that the FSB made its designations [of G-SIIs] without saying how it applied the IAIS methodology to any particular issuer."[35] To the extent that the FSB wishes to develop

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[32] Inv. Co. Inst., *2013 Investment Company Fact Book* 1, 24 (2013), *available at* http://www.ici.org/pdf/2013_factbook.pdf.
[33] *Id.* at 25.
[34] Financial Stability Board & OICU-IOSCO*, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* 1, 2 (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.htm.
[35] *The Growth of Financial Regulation and its Impact on International Competitiveness: Hearing Before H. Comm. on Fin. Services,* 113th Cong. 1, 5 (Mar. 5, 2014) (statement of Peter Wallison,

entity-specific methodologies for NBNI entities, the methodologies should be objective, rigorous, consistent, and transparent.

The Committee has previously expressed its concerns as to "the potential for confusion arising from different designations by"[36] FSOC and the FSB and its affiliates. Pursuant to the recent report of the U.S. Office of Financial Research of the U.S. Treasury on the systemic riskiness of asset managers,[37] U.S. regulators are currently considering whether and to what extent to subject asset managers to the SIFI designation process,[38] and FSOC has previously solicited comment on its authorities to designate non-bank SIFIs.[39] As discussed above, the FSB has proposed its own set of designation methodologies with respect to G-SIBs, G-SIIs, and NBNI G-SIFIs. We are concerned that this multiplicity of potential assessment methodologies and designation processes will court confusion and contradictory policymaking.

For example, in the event that U.S. regulatory authorities appropriately opt *not* to designate asset managers or investment funds (or other NBNI entities subject to its jurisdiction) as systemically important, the Committee believes that this fact should be determinative as to the FSB's parallel designation process with respect to the same types of entities. At a minimum, the two determinations should be closely coordinated. The Committee favors a broadly consultative approach between the FSB and U.S. regulatory authorities. The U.S. Treasury and Federal Reserve are both member organizations of the FSB, and as such, any decisions taken by the FSB with respect to G-SIFI designation are likely to have a substantial effect on the future course of domestic SIFI designations by FSOC. Before taking the drastic step of G-SIFI designation of NBNI entities, we recommend that the FSB convene roundtables in key global jurisdictions, including the United States, to shed light on its own decision-making internal processes.

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Thank you very much for your consideration of our views. Should you have any questions or concerns, please do not hesitate to contact Prof. Hal S. Scott

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American Enterprise Institute), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-113-ba09-wstate-pwallison-20140305.pdf.

[36] Letter from Comm. on Capital Mkts. Reg. to International Association of Insurance Supervisors 1, 4 (Jul. 31, 2012), *available at* http://capmktsreg.org/pdfs/2012.07.3_IAIS_comment_letter.pdf.

[37] U.S. Dep't of the Treasury Office of Fin. Research, *Asset Management and Financial Stability* 1 (Sept. 2013), *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

[38] Letter from Comm. on Capital Mkts. Reg. to Elizabeth M. Murphy, Secretary, U.S. Sec. and Exch. Comm. 1 (Nov. 1, 2013), *available at* http://capmktsreg.org/wp-content/uploads/2013/11/CCMR-asset-mgr-comment-ltr-2013-11-01.pdf.

[39] Letter from Comm. on Capital Mkts. Reg. to Neal Wolin, Acting Chairman, Fin. Stability Oversight Council 1 (Feb. 15, 2013), *available at* http://capmktsreg.org/wp-content/uploads/2013/02/FSOC.non-bank.SIFI_.comment.ltr_..pdf.

(hscott@law.harvard.edu), Director of the Committee on Capital Markets Regulation, at your convenience.

Respectfully submitted,

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